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450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
916-324-2056 • FAX 916-323-3387
www.boe.ca.gov

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January 4, 2006

FACSIMILE

Re: Change in Ownership - Sprinkle/Spray Trust Provisions-Identifying "Present" Trust Beneficiaries.

Dear Mr. _____,

This is in response to your September 30, 2005 email to Kristine Cazadd, Chief Counsel, and follow-up inquiries, regarding how the property tax law would apply where the class of beneficiaries was defined prior to 1975 based on the facts described below. This letter supersedes all previous email correspondence on this issue.

FACTUAL BACKGROUND

1. A & B, husband and wife, established a Trust in 1963 (referred to as "the 1963 Trust" or "the Trust"). The Trust became irrevocable before 1975.
2. Prior to 1975, the irrevocable 1963 Trust was divided into three identical irrevocable sub-trusts, one for each of A and B's three children, C, D & E. C & D are elderly; E died after 1975. It is presumed that each child is the trustee of their sub-trust.
3. C, D & E each have issue.
4. Each of the sub-trusts has the following beneficial provisions:

A. At all times since March 1, 1975, the trustees have had the "absolute discretion to allot, pay and/or accumulate the net income of such trust. . . . The persons, who will be referred to herein at times as 'income beneficiaries', to whom the net income . . . shall be allotted or paid, or for whose benefit it may be accumulated, shall consist in [trustors' child], the issue of such child, the spouse of such child while such spouse is living with such child as his or her spouse and the spouse of any issue of such child while such spouse is living with such issue as his or her spouse. . . . [T]he trustees, in their absolute discretion shall at any time and from time to time select the income beneficiary or beneficiaries, to whom the net income of each of said trusts is to be allotted or paid or for whose benefit it is to be accumulated; and the trustees, in their absolute discretion, shall determine at any time and from time to time the amounts or proportions (which

may be equal or unequal) in which the net income . . . is to be allotted, paid or accumulated." In substance, the 1963 Trust allows the trustees to determine what portion of the net income is to be accumulated and what portion is to be allocated to each permissible income beneficiary and then to determine as to each permissible income beneficiary what portion is to be distributed currently and what portion is to be accumulated in a separate "accumulation trust" for that beneficiary, with the trustees having the power to make future distributions to that beneficiary from his or her accumulated trust.

B. Each child beneficiary is granted a testamentary limited power of appointment over his or her accumulation trust, and in absence of the exercise of such power of appointment, at the beneficiary's death, the balance of his or her accumulation trust is to be distributed to his or her issue by right of representation, or if none, to A's & B's issue by right of representation. However, there is a continuing Trust for any issue until he or she attains age 25.

C. Undistributed income of the 1963 Trust is to be added to principal, and the trustees are granted the power "to pay to and/or apply for the use and benefit of any person who shall be a beneficiary of any accumulation trust so much of the principal thereof as the trustee may determine. . . ."

D. At the death of each child of A & B, that child's Trust is to be distributed to that child's issue by right of representation; however, each child is granted a testamentary limited power of appointment which may be exercised in favor of that child's spouse (but only as to 50% or less) and issue.

At E's death, he exercised his testamentary limited power of appointment to extend the term of his sub-trust, for at least another generation, so that at his death the sub-trust would not terminate. He did not change the definition of the original class of permissible beneficiaries under the Trust.

Your questions are restated below followed by our response that is based on our telephone conference with Ms. Cazadd on November 29, 2005, and our subsequent telephone calls.

LAW AND ANALYSIS

A. Sprinkle Power Provision/ Defining the Class of Present Beneficiaries

Property Tax Rule 462.160 provides that "Where a trustee of an irrevocable trust has total discretion ("sprinkle power") to distribute trust income or property to a number of potential beneficiaries, the property is subject to change in ownership, because the trustee could potentially distribute it to a non-excludable beneficiary, unless all of the potential beneficiaries have an available exclusion from change in ownership."

Based on the foregoing rule provision, it has been our position that beneficial interests are not ascertainable if the trustee has discretion to sprinkle income or principal for the benefit of any or all beneficiaries. If the beneficial interests cannot be ascertained, it necessarily follows that exclusions from change in ownership cannot be determined because the trustee may distribute any or all to some beneficiaries and omit other beneficiaries. Therefore, in a trust which provides that the trustee may exercise a sprinkle power and where the group of

beneficiaries includes some persons to whom exclusions are available and some to whom no exclusions are available, then it is treated as though no exclusions were available.

As a result of the Sprinkle/Spray Provision, it is our opinion that a 100 percent change in ownership of the Trust property, which was distributed to the three sub-trusts, would have occurred if trustors A & B had died after the effective date of Proposition 13, because the trustee could potentially distribute it to a non-excludable beneficiary and there would not have been an applicable exclusion for all beneficiaries until 1986 (parent/child) and 1996 (grandparent/grandchild).

Based on the facts, however, the "Sprinkle/Spray Provisions" of Paragraph A of both the Trust and each sub-trust were exercised before March 1, 1975. Each sub-trust specify that C, D, and E, their respective spouses, and their issue/descendants and their spouses were present beneficiaries of the Trust, which became irrevocable at the death of A and B. With the present right to receive distributions of the Trust income, all these individuals, including all future, but as yet, unborn children, became present beneficiaries and thus the "owners" of the property, since the trustees accumulated the income for each of them at that time. Whenever a child was born thereafter or whenever a child or their issue or descendant died, the fractional interest of that beneficiary transferred.

B. Beneficiaries' Interests

We discussed whether because the Trust does not specify a fixed interest for each beneficiary, all beneficiaries will be presumed to have equal interests in the property. For example, if there were 20 beneficiaries in existence for E's sub-trust when the 1963 Trust became irrevocable, then each beneficiary would be presumed to have a 1/20th interest in the sub-trust's property.

Our research in California Probate Code Sections 245 through 247 "Distribution Under a Will, Trust or Other Instrument", confirmed that in Section 245 equal shares may be assumed in such circumstances. Section 245 provides: "When a will or trust that expresses no contrary intention provides for issue or descendants to take without specifying the manner, it is governed by Section 240", which addresses the equal division of property among beneficiaries. Although, we were unable to find any statute or law that specifically states that beneficiaries of a trust with sprinkle provisions are treated as having equal interests for property tax purposes, we believe that the Legislature would favor this interpretation. Moreover, for ease in the administration of the property tax law, we have always taken the position that if the trust instrument does not otherwise state the intended interests, the trustors are presumed to have gifted the estate equally among all the beneficiaries.

C. Applicable Exclusions

Revenue and Taxation Code section 63¹ pertains to interspousal transfers. It provides, in relevant part, that "a change in ownership shall not include any interspousal transfer[.]"

Section 63.1 provides, in relevant part, for the exclusion from change in ownership, under specified conditions, of certain transfers of real property between parents and children and from

¹ Hereafter section references are to the Revenue and Taxation Code, unless otherwise noted.

grandparents to grandchildren. Subdivision (c)(9) defines the term "transfer" to include "any transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust." Section 60 defines a change in ownership as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." For purposes of change in ownership, the present beneficiary or beneficiaries of an irrevocable trust hold the present, beneficial interest in the property within the meaning of section 60.

Please note that the parent/child exclusion would apply only to any transfer that occurred on or after November 6, 1986, and the grandparent/grandchild exclusion would apply only to any transfer that is made on or after March 27, 1996.

However, if the interests in the real property are "fractional," an applicable exclusion may be found in section 65.1, subdivision (a), which relates to the transfers of de minimis interests in real property. This exclusion states, in pertinent part, that the transfer of a tenancy-in-common interest is excluded from change in ownership when:

The transfer is of an undivided interest(s) of less than five percent of the value of the total property and has a value of less than \$10,000; provided however, that transfers of such interests during any one assessment year (the period from March 1 through the last day in February of the following year) shall be accumulated for the purposes of determining the percentage interest and value transferred. When the accumulated interests transferred during any assessment year equals or exceeds five percent of the value of the total property or \$10,000, exclusive of any interest transferred to a spouse or other exempt transfer, only that percentage of the property represented by the accumulated interests shall be reappraised.

Whether the "fractional interests" transferred actually represents less than 5 percent of the value of the properties and had a value of less than \$10,000 is a question of fact for the assessors to determine.

In the event that the percentage interest limit or \$10,000 value limit was exceeded, the foregoing exclusion would not be applicable, but the parent/child exclusion or grandparent/grandchild exclusion under section 63.1 could possibly exclude the transfer as part of the first \$1 million dollars in full cash value of real property as a transfer from A and B or C, D and E to their children and grandchildren.

Applying the foregoing analysis to the questions submitted, the answers to your questions are set forth below.

1. Is there a "change in ownership" after the effective date of Proposition 13 by reason of the death, after such effective date, of an individual who is in the original class of permissible beneficiaries (e.g. E)?

Response: Yes, since these beneficiaries are now deemed the owners of the property. However, there is a change in ownership only to the extent of the interests transferred to a beneficiary without an applicable exclusion (i.e., parent/child and grandparent/grandchild

exclusion of section 63.1, the interspousal exclusion of section 63, and/or the exclusion in section 65.1, subdivision (a).)

2. If the answer to question #1 above is yes, then what percentage of the real property owned by the sub-trust is considered to have undergone a "change in ownership"?

Response: Upon the transfer of an undivided interest in property, only the interest or portion transferred will be reappraised. Therefore, only the deceased beneficiary's interest would be subject to a reappraisal.

3. Is there a "change in ownership" after the effective date of Proposition 13 by reason of the birth, after such effective date, of an individual who becomes a member of the original class of the permissible beneficiaries?

Response: Yes, under the given facts, a birth results in a change in ownership since the 1963 Trust authorizes the trustees to distribute a "present interest" to C, D, and E, their respective spouses, and their issue/descendants and their respective spouses. This included all future, but as yet, unborn children of these permissible beneficiaries.

4. If the answer to question #3 above is yes, then what percentage of the real property owned by the sub-trust is considered to have undergone a "change in ownership"?

Response: Only the interest or portion transferred to the newborn child will be reappraised where there are no applicable exclusions.

5. Is there a "change in ownership" by reason of E's exercise of his limited power of appointment to extend the term of his sub-trust, and if so, at what point in time.

Response: No, generally, interests created by powers of appointment (special or general) are treated as "future interests" and thus, do not affect the present beneficiary's present enjoyment of the property, except in certain instances (involving a general power) for purposes of determining the "amount" of the \$1 million exclusion available. Neither the granting nor the exercise of this power results directly in a change in ownership and reappraisal of the property. (See attached Annotation No. 625.0210, dated 1/21/92.)

With the above in mind, there is no change in ownership since E's power of appointment only prevented the termination of the sub-trust at his death and provided a future interest for the future generation.

6. As to each "change in ownership" you identify, who is the transferor for purposes of the parent/child exclusion and the grandparent/grandchild exclusion?

Response: Based on the facts, the 1963 Trust defined permissible income beneficiaries to include A & B's children (C, D, and E) and their respective spouses, and their issue/descendants and their respective spouses and there is no reversion. At the death of each child of A & B, that child's sub-trust is to be distributed to that child's issue by right of representation; however, each child is granted a testamentary limited power of appointment which may be exercised in favor of that child's issue.

Therefore, upon the death of C, D, and E, the balance of the sub-trust is distributed to that child's issue by right of representation. Accordingly, A and B are the transferors upon the death of their children (C, D, & E), unless that child exercises his/her limited power of appointment.

Here, E exercised his testamentary limited power of appointment to extend the term of his sub-trust at his death so that the sub-trust would not terminate and be distributed. Thus, as to E's issue (children, grandchildren, etc.), E is now the transferor.

Additional Questions Presented in November 2005 Emails:

- a) **If, for example, the class of permissible beneficiaries at a given point in time is 15, and if one of the beneficiaries dies, what would occur upon the death of a second beneficiary? In other words, will each death trigger a 100% "change in ownership"?**

Response: No, as stated above in question #2, upon the death of any given permissible beneficiary there is a change in ownership of that beneficiary's interest only.

- b) **If, for example, the class of permissible beneficiaries at a given point in time is 15 and the trust terminates and distributes the real property in equal shares to the 15 beneficiaries, what would be the property tax consequences?**

Response: No change in ownership, because the class of permissible beneficiaries holds the present beneficial interest as the present beneficiaries of the trust and receive legal title only through the distribution.

Section 60 defines a change in ownership as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." When real property is transferred to an irrevocable trust, the present beneficial interest in the property transfers to the present beneficiary or beneficiaries if they are persons other than the trustor or the trustor's spouse pursuant to Property Tax Rule 462.160, subsections (a) and (b)(1)(A). When an irrevocable trust terminates and the property interests held by the trust are distributed to the present beneficiaries, there are no transfers of the present beneficial interests and, therefore, no changes in ownership occur. In *Allen v. Sutter County Bd. of Equalization* (1983) 139 Cal.App.3d 887, the court of appeal held that the termination of an irrevocable trust and distribution of the trust real property did not result in a change in ownership.

- c) **(1) The trustee of one of the three original sub-trusts is contemplating forming a Limited Liability Company (LLC) to hold that trust's interest in the real property for management and liability purposes. For purposes of the rules of Sections 62(a)(2), 64(c) and 64(d), who are the owners of the LLC - the trusts or the beneficiaries?**

Response: The beneficiaries. For purposes of change in ownership, when a trustor creates and transfers property into an irrevocable trust in which a person other than the trustor or the trustor's spouse is the present beneficiary, the trustor-transferor is considered to have transferred the present beneficial interest in the property to the present beneficiary. Such a transfer results in a change in ownership pursuant to Revenue and Taxation Code section 60 because it constitutes "a transfer of a present interest in the property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." When the sub-trusts were created,

the present beneficial interest in the property used to fund the sub-trusts vested in the beneficiaries. If each sub-trust beneficiary creates an LLC and transfers his/her respective property into the LLC in exchange for capital and profits interests, each present beneficiary of each sub-trust will at that time become the indirect owners of the property held by the LLC. The exclusion in section 62, subdivision (a)(2), would apply if the capital and profit interests each beneficiary received from the LLC was proportional to the property interests each transferred to it.

(2) If it is the beneficiaries, does the property tax law assume that each beneficiary has an equal interest for purposes of determining whether transferring the real property to the LLC qualifies for the 62(a)(2) exclusion?

Response: Yes, as discussed above, since the Trust does not specify a fixed interest for each beneficiary, all beneficiaries are presumed to have equal interests in the property.

(3) Or, for this limited purpose, does the property tax law recognize the trust as the transferor of its interest in the real property, in which case how could you apply the rules of Sections 64(c) and 64(d)?

Response: Not applicable, see response to (1) above.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,

/s/ Shirley Johnson

Shirley Johnson
Tax Counsel

SJJ:jlh

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cc: Honorable
California Assessors' Association

Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Todd Gilman, MIC:70
Ms. Glenna Schultz, MIC: 64